Watson Wyatt
Worldwide

Memo

June 6, 2007

To: CalPERS Performance and Compensation Committee

From: Rick Beal, Watson Wyatt

Subject: **Agenda Item: Proposed Revisions to Investment Manager Performance Award Plans**

The purpose of this memorandum is to outline Watson Wyatt's thoughts on the **Agenda Item: Proposed Revisions to Investment Manager Performance Awards Plans**. Watson Wyatt's overall view on the proposed changes to the investment performance awards program is favorable. However, we believe there our several areas of importance to best practices in incentive design that will need to be carefully crafted to avoid unintended consequences and to maximize the intended pay for performance effect.

Alignment with Overall Fund Performance. The goal of more closely aligning the incentive awards with the overall goals of the investment program is consistent with good incentive design. Furthermore the goal of requiring all levels of investment managers to have some incentive tied to the overall fund performance is consistent with this goal as well. The existing overall fund performance incentive tiers are consistent with the line-of-sight issues that we have discussed with the Committee previously. The replacement of the qualitative measures with a leadership measure has served to clarify the purpose and intended behaviors associated with achievement of qualitative results. At the next meeting when the revised plans are presented it will be appropriate to display the incentive metric weights for each position and a summary chart for all of the position levels to assist the Committee in understanding the impact of the overall program.

Performance Against Benchmarks. The major change in the area of benchmarks appears to be the scaling from minimum through target to maximum. The agenda item notes that payouts at target (which has been discussed previously with the Committee as achievable but stretch performance) are currently a linear interpolation on a scale of .5 to 1.5 with performance at below the minimum receiving a zero value. The existing description of the target as stretch performance is typical in most incentive plans and the intent of the current linear award structure has been as follows:

- zero awards for performance below the minimum
- 50% of target at the minimum
- From 50% up to 100% of the target award payout calibrated as achievable but stretch performance
- From 100% to 150% of target for the very high level of performance required to exceed the achievable but stretch target

Award Progression and Target Definition. The existing linear award payout progression results in only paying for very strong performance assuming that the target is set appropriately at achievable but stretch performance. This supports the pay for performance philosophy underpinning the incentive design. Effectively fewer incentive dollars are paid for non-stretch performance than for stretch performance and for exceeds stretch performance.

The proposed approach simplifies the terminology by eliminating the target terminology and introducing a mid value that is non-stretch, achievable performance. In order to avoid paying more for a lower level of performance the proposal recommends changing the payout scale to run from a zero percent award at the minimum to a maximum or 100% payout at the maximum level of performance. The mid value would produce a payout of 50% of the maximum unlike the old target award that provided payouts of 2/3 of the maximum. The current linear interpolation methodology for payouts would simply be applied to the full range of incentive opportunity from 0% to 100% of the maximum. This would simplify the calculation and communication.

Performance Metric Range. The common sizing of the minimum and maximum may establish minimums and maximums at points lower and higher than the existing metrics. While this may make it easier to achieve a minimum level of award, the rescaling of the payouts from 0% to 100% of maximum will significantly reduce the value of an award for minimum performance. In addition it may become more difficult to achieve a maximum award.

Watson Wyatt supports a change to the performance metric scale tied to a corresponding change in the performance payout scale. As always changes in this aspect of a program have the potential for unintended consequences in terms of incentive behavior and as such Watson Wyatt believes it wise to phase in these changes over time. Changes in this aspect of the program design would benefit from a graphic display and illustrative examples at the next meeting.

Performance versus Public Peers. The introduction of a metric of performance relative to other funds is a common metric for measuring asset managers in the private sector where investors pursue active managers who can outperform the market and their peers. The challenges for this type of metric lie in the rationale for the identification of the peers and the consistency of the peer group over time. The more stable the group, the more useful the performance metric. One issue to consider is the risk of payouts in down years simply because the CalPERS fund outperformed other negatively performing funds.

Performance versus Actuarial Target. The goals of having a metric that aligns the awards with improving the funding ratio of the pension plan and ties with the cost of capital for CalPERS is an appropriate measure. Using a premium over the Consumer

Price Index as a cost of capital metric is an approach that reflects CalPERS' performance however it is less clear what investment behaviors are likely to occur upon implementation of this metric.

Investment Efficiency. The introduction of investment efficiency as a metric is one that has been considered by many of the public pension funds that have incentive plans and has been introduced at some of these funds. The primary reason for non-introduction has been the concern about the added complexity. This topic was introduced as a discussion item in 2004 before CalPERS' Performance and Compensation Committee. In 2004 this item was withdrawn in order to focus on changes to the base pay program and because it was determined that introducing risk budgeting into the incentive metrics was too dramatic a change at that time. Factors influencing this decision included:

- Concerns raised by members of the investment staff about consistency of alignment between CalPERS portfolio managers and with outside fund managers
- Questions about how much control the investment staff had over the degree of risk
- Concerns about the ability to apply risk measures to real estate and alternative investments
- Concerns about the ability to apply risk measures to short time periods.

Because of these concerns the current agenda item recommends that this aspect of the proposed changes should be studied further before implementation for the benchmarks below the level of the total fund. One question would be how the overall fund investment efficiency ratio would be compiled. If the overall fund is a rollup of the sub funds and some of the sub funds are difficult to measure, the overall fund would also be difficult to measure.

Assuming these issues can be addressed and risk measurement is introduced at the level below the total fund then there is an additional concern involving the addition of another metric for each of the investment fund benchmarks. The net effect for the portfolio managers may be the dilution of the metrics due to the diminished weights per metric.

Multiyear Performance Horizons. The agenda item recommends the continuation of the existing multiyear performance horizons and displays a chart of the effective weightings. Watson Wyatt supports the continuation of this approach as it aligns with CalPERS investment horizon.

Summary

Watson Wyatt believes the effort to review the incentive design is appropriate and the principles presented are sound. Nevertheless redesign should be approached carefully in order to avoid unintended consequences.